

REPORT OF EXAMINATION
OF THE
ASSOCIATED INDEMNITY CORPORATION
AS OF
DECEMBER 31, 2007

Participating State
and Zone:

California

Filed June 19, 2009

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San Francisco, California
June 15, 2009

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Morris Chavez
Secretary, Zone IV-Western
Superintendent of Insurance
New Mexico Department of Insurance
Santa Fe, New Mexico

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

ASSOCIATED INDEMNITY CORPORATION

(hereinafter also referred to as the Corporation) at its home office located at 777 San Marin Drive, Novato, California 94998.

SCOPE OF EXAMINATION

The previous examination of the Corporation was made as of December 31, 2003. This examination covers the period from January 1, 2004 through December 31, 2007. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Corporation's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2007, as deemed necessary under the circumstances.

The Corporation is a participant in an intercompany reinsurance agreement with eight of its affiliates (the participants). The lead insurer is Fireman's Fund Insurance Company (FFIC). Under the terms of this agreement, the participants cede, and FFIC assumes, 100% of the participants' business generated from underwriting operations. The cessions from the participants are combined with FFIC's business, resulting in the pooled balance to be allocated to each participant. In order to examine the Corporation's assets and liabilities that resulted from pooling, it was necessary to review this pooled balance. Each company in the pool was examined concurrently by its respective state of domicile.

In addition to those items specifically commented upon in this report, other phases of the Corporation's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

SUMMARY OF SIGNIFICANT FINDINGS

As a result of this examination, surplus as regards policyholders as of December 31, 2007 has been reduced by \$8,070,859 to \$63,765,313. The reduction in surplus was due to increases in the Corporation's losses and loss adjustment expense reserves, primarily related to asbestos and environmental reserves, as well as minimum reserve amounts for loss and loss adjustment expenses as required by California Insurance Code Section 11558.

SUBSEQUENT EVENTS

The Fireman's Fund group of insurance companies (Group) underwent significant restructuring in August 2008. The Executive Committee of the Corporation's upstream affiliate, Allianz of America, Inc., made the decision to decentralize support services by aligning these services more closely with the operating companies. As a result, business functions that included Legal, Information Technology, Compliance, and Marketing were realigned so that these functions would be managed

independently by Fireman's Fund Insurance Company and Allianz Life Insurance Company of North America.

Additionally, specialty marine business was combined with Allianz Global Corporate & Specialty's (AGCS) global marine business into a new Allianz unit, AGCS Marine Insurance Company (AMIC), that will be managed by AGCS. Agribusiness, a major contributor to the Group's profitability in the last few years, is now operated as a dedicated unit. The other portions of Specialty Insurance were combined with Commercial Business to form a new commercial and specialty risks organization. As a result, the Group currently has two primary business units: Personal and Commercial.

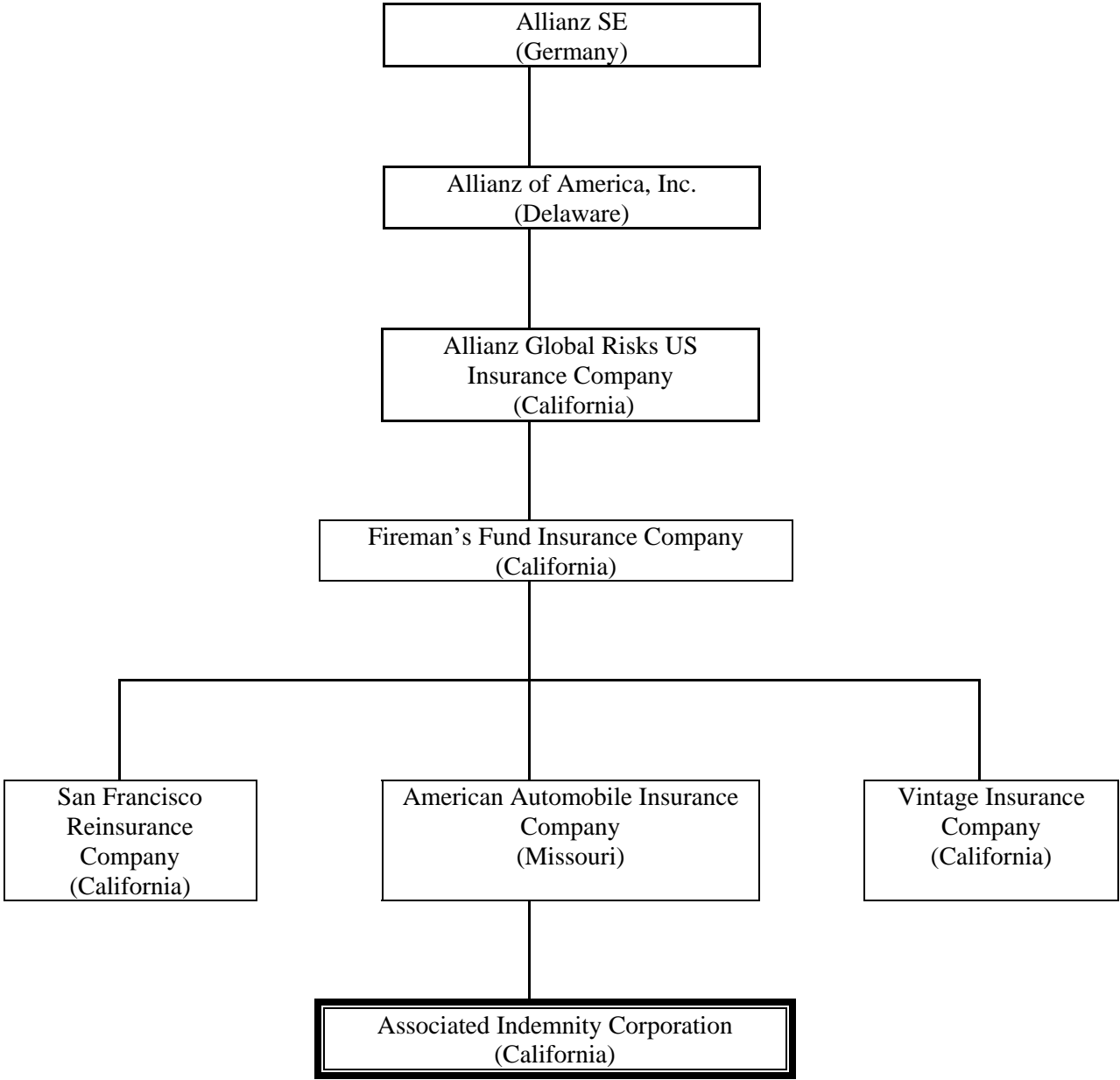
COMPANY HISTORY

The Corporation began business in 1923 as the Associated Industries Insurance Corporation. In 1927, the Corporation's name was changed to Associated Indemnity Corporation. The Corporation is a wholly owned subsidiary of American Automobile Insurance Company, which in turn is a wholly owned subsidiary of Fireman's Fund Insurance Company.

The Corporation is authorized to issue 500,000 shares of common stock with a par value of \$40 per share. As of December 31, 2007, there were 87,500 shares outstanding.

MANAGEMENT AND CONTROL

The Corporation is a member of an insurance holding company system. Allianz SE (doing business as a Societas Europaea company), formerly Allianz Aktiengesellschaft (Allianz AG) is a European Company incorporated in the Federal Republic of Germany and the European Union. Allianz SE is the ultimate controlling entity. The following chart depicts the interrelationship of the Corporation and its California affiliates within the holding company system (all ownership is 100%):



Members of the board of directors, who are elected annually, manage the business and affairs of the Corporation. Following are members of the board and principal officers of the Corporation serving at December 31, 2007:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Bruce F. Friedberg Novato, California	Senior Vice President and Chief Actuary Fireman's Fund Insurance Company
Louise Jordan ^(a) San Rafael, California	Senior Vice President and Controller Fireman's Fund Insurance Company
Jill E. Paterson ^(b) Tiburon, California	Executive Vice President and Chief Financial Officer Fireman's Fund Insurance Company
Cynthia L. Pevehouse ^(c) Tiburon, California	Senior Vice President and Secretary Fireman's Fund Insurance Company
Linda E. Wright ^(d) Tiburon, California	Senior Vice President and Treasurer Fireman's Fund Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Charles M. Kavitsky ^(e)	President and CEO
Jill E. Paterson ^(b)	Executive Vice President and Chief Financial Officer
Cynthia L. Pevehouse ^(c)	Senior Vice President and Secretary
Linda E. Wright ^(d)	Senior Vice President and Treasurer

The following changes in management occurred subsequent to the examination date:

- ^(a) Louise Jordan transferred to Allianz SE in Munich, Germany in June 2008. Jeffery Johnson, Assistant Controller, was promoted to Vice President and Controller.
- ^(b) Jill Paterson was elected Treasurer effective October 28, 2008. Her current title is Executive Vice President, Chief Financial Officer and Treasurer.
- ^(c) Cynthia Pevehouse was elected Executive Vice President, General Counsel and Secretary at Allianz of America Corporation. Sally Narey replaced Ms. Pevehouse as Senior Vice President, General Counsel and

Secretary effective September 8, 2008.

- (d) Linda Wright was replaced as Treasurer by Jill Paterson effective October 28, 2008.
- (e) Charles Kavitsky was elected as Chairman of the Board effective January 1, 2008. In January, 2009 the Corporation announced that Mr. Kavitsky will retire effective July 31, 2009. Michael LaRocco was named President and CEO effective March 17, 2008.

Management Agreements

Tax Reimbursement Agreement: Effective December 17, 1999, the Corporation entered into a Tax Reimbursement Agreement for the purpose of clarifying an agreement that was in effect since 1991. The Tax Reimbursement Agreement was between Allianz of America, Inc. (AZOA) and its affiliates, including the Corporation. Under this agreement, the tax liability of the Corporation will be computed as if it filed a separate stand-alone return. AZOA is the party primarily responsible for filing and making all tax payments on behalf of the Corporation.

Investment Management Services Agreement: Effective January 1, 1981, the Corporation and several of its affiliates entered into an investment management services agreement with Fireman's Fund Insurance Company (FFIC). This agreement has been amended on numerous occasions to add or remove affiliates as a party to the agreement. Under the provisions of the agreement, FFIC agrees to supply investment management services to the other parties. In consideration, the other parties agree to share the costs of furnishing the above investment management services.

TERRITORY AND PLAN OF OPERATION

The Corporation is licensed to transact insurance in all states of the United States and in the District of Columbia. Under the terms of the intercompany reinsurance agreement, most of the underwriting transactions of the Corporation are pooled, reapportioned and then distributed to the nine members of the pool, as discussed under the caption Reinsurance.

The Corporation conducts its operations jointly with other subsidiaries of Fireman's Fund Insurance Company (FFIC) through its home office in Novato, California. As of December 31, 2007, the underwriting operations of FFIC's group of insurance companies (Group) were conducted through

four business units: Commercial, Personal, Specialty (includes Marine, Specialty Casualty and Crop), and Resolution Services, previously called Discontinued Operations (businesses deemed unprofitable or non-strategic).

For the period ending December 31, 2007, approximately one quarter of the Group's direct business was generated in California. Commercial line business generated a large portion of the Group's total business with approximately 34% of gross premium. Personal lines business represented 24% of gross premium. Specialty lines business produced the largest percentage, representing approximately 42% of total gross premium in 2007. Specialty lines include marine, specialty casualty and crop insurance coverages. With the acquisition of William H. McGee, the Group became the largest cargo insurer in the United States and has a strong position in the inland marine market. The Group's Crop Insurance program offers products tailored to the specific needs of the agricultural sector, including multi-peril crop insurance (MPCI), crop hail, and livestock coverages. FFIC and Rural Community Insurance Services, Inc. (RCIS), an unaffiliated multi-peril crop MGA, are in a partnership whereby RCIS administers MPCI business with 80% of the writings ceded back to the Company. The Company then retrocedes 37.5% to Empire Fire and Marine.

In August 2008, the Group underwent significant restructuring. Specialty marine business was combined with Allianz's Global Corporate Specialty's (AGCS) global marine business into a new Allianz unit, AGCS Marine Insurance Company (AMIC), that will be managed by AGCS. Agribusiness, a major contributor to the Group's profitability in the last few years, will be run as a dedicated unit. The other portions of the Specialty Insurance will be combined with Commercial Business to form a new commercial and specialty risks organization. As a result, the Group will have two primary business units: Personal and Commercial.

REINSURANCE

Intercompany Reinsurance Agreement

The Corporation is a participant in an intercompany reinsurance agreement with eight of its affiliates (the participants). The lead insurer is Fireman's Fund Insurance Company (FFIC). Under the terms of this agreement dated January 1, 1999 and amended January 1, 2003, the participants cede, and FFIC assumes, 100% of the participants' business generated from underwriting operations. The cessions from the participants are combined with FFIC's business, resulting in the pooled balance to be allocated to each company in the pool. The following table illustrates each participant's pooled share as of December 31, 2007:

Company	State of Domicile	Pooling Share
Fireman's Fund Insurance Company	CA	75.0%
The American Insurance Company	OH	11.5%
National Surety Corporation	IL	4.0%
Interstate Fire & Casualty Company	IL	3.5%
American Automobile Insurance Company	MO	2.5%
Chicago Insurance Company	IL	1.5%
Associated Indemnity Corporation	CA	1.0%
Interstate Indemnity Company	IL	0.8%
Fireman's Fund Insurance Company of Ohio	OH	<u>0.2%</u>
Pool Total		<u>100.0%</u>

The agreement authorizes and empowers FFIC to (1) collect and receive all premiums, (2) adjust and pay all losses, (3) reinsure or cancel any and all policies and contracts of insurance, and (4) act as though the policies and contracts of insurance and reinsurance were issued by FFIC. It further provides for the complete sharing of all income and expenses of the pooled business with the exception of the investment operations, liabilities for federal income tax or other items not relating to the underwriting operations of the parties. Accounts are required to be settled quarterly.

Other companies within the Fireman's Fund Group, referred to as Specialty Companies, cede 100% to the pool, but do not assume any portion of the pooled balances. These companies receive a commission from FFIC and also pay FFIC a management fee, resulting in minimal income. Three

companies in the pool, Interstate Fire & Casualty Company, Interstate Indemnity Company, and Chicago Insurance Company, submit business to the pool net of external reinsurance arrangements with third parties.

Assumed

The Corporation does not assume reinsurance from third parties.

Ceded

Reinsurance, other than intercompany, is placed by FFIC for the Fireman's Fund Group. All members of the Group, either individually or collectively, may utilize the reinsurance of the various contracts that are in effect.

ACCOUNTS AND RECORDS

Information Systems Controls

During the course of the examination, a review was made of the Corporation's general controls over its information systems. As a result of this review, several low risk findings were noted in controls over logical security. These findings were presented to the Corporation along with recommendations to strengthen its controls. The Corporation should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

Federal Income Taxes

Currently the methodology being used for measuring temporary book/tax differences is not in compliance with Statement of Statutory Accounting Principles (SSAP) No. 10, paragraph 6.a. which states "Temporary differences are identified and measured using a balance sheet approach whereby statutory and tax basis balance sheets are compared." The Corporation currently uses an income statement approach where the current year non-taxable amounts are added/subtracted from last year's

cumulative timing difference. The updated cumulative timing difference is used to support the deferred tax asset or liability. The balance sheet approach is preferred in order to assure completeness and accuracy of the deferred tax inventories, particularly where the tax basis calculations are complicated and are developed over several years. It is recommended that the Corporation identify and measure temporary differences using a balance sheet approach in compliance with SSAP No. 10, paragraph 6.a.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2007

Underwriting and Investment Exhibit for the Year Ended December 31, 2007

Reconciliation of Surplus as Regards Policyholders from December 31, 2003
through December 31, 2007

Reconciliation of Examination Changes as of December 31, 2007

Statement of Financial Condition
as of December 31, 2007

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 141,696,975	\$	\$ 141,696,975	
Cash and short-term investments	42		42	
Other invested assets	1,107,459		1,107,459	
Receivable for securities	184,370		184,370	
Investment income due and accrued	1,315,836		1,315,836	
Premiums and agents' balances in course of collection	10,220,369	795,884	9,424,485	
Premiums, agents' balances and installments booked but deferred and not yet due (including \$168,004 earned but unbilled premiums)	4,984,423	17,793	4,966,630	
Accrued retrospective premiums	22,109	1,399	20,710	
Amount recoverable from reinsurers	8,649,076		8,649,076	
Net deferred tax asset	5,087,518	2,790,233	2,297,285	
Guaranty funds receivable or on deposit	219,831		219,831	
Receivables from parent, subsidiaries and affiliates	7,544,905		7,544,905	
Aggregate write-ins for other than invested assets	<u>192,701</u>		<u>192,701</u>	
Total assets	<u>\$ 181,225,614</u>	<u>\$ 3,605,309</u>	<u>\$ 177,620,305</u>	
 Liabilities, Surplus and Other Funds				
Losses and loss adjustment expenses			\$ 64,112,000	(1)
Reinsurance payable on paid loss and loss adjustment expenses			3,465,212	
Commissions payable, contingent commissions and other similar charges			1,348,676	
Other expenses			897,271	
Taxes, licenses and fees			444,804	
Current federal and foreign income taxes			3,551,430	
Unearned premiums			19,630,132	
Advance premiums			14,380	
Dividends declared and unpaid: Policyholders			19,238	
Ceded reinsurance premiums payable			18,318,181	
Aggregate write-ins for liabilities			<u>2,053,668</u>	(2)
Total liabilities			113,854,992	
Common capital stocks		\$ 3,500,000		
Gross paid in and contributed surplus		13,005,856		
Unassigned funds (surplus)		<u>47,259,457</u>		
Surplus as regards policyholders			<u>63,765,313</u>	
Total liabilities, surplus and other funds			<u>\$ 177,620,305</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2007

Statement of Income

Underwriting Income

Premiums earned		\$ 46,480,179
Deductions:		
Losses and loss expenses incurred	\$ 34,824,893	
Other underwriting expenses incurred	<u>14,710,570</u>	
Total underwriting deductions		<u>49,535,463</u>
Net underwriting loss		(3,055,284)

Investment Income

Net investment income earned	\$ 6,788,507	
Net realized capital gain	<u>95,434</u>	
Net investment gain		6,883,941

Other Income

Net loss from agents' or premium balances charged off (amount recovered \$6,041 amount charged off \$58,950)	\$ <u>(52,909)</u>	
Total other income		<u>(52,909)</u>
Net income before dividends to policyholders, after capital gains and before federal and foreign income taxes		3,775,748
Dividends to policyholders		<u>60,286</u>
Net income after dividends to policyholders, after capital gains and before federal and foreign income taxes		3,715,462
Federal and foreign income taxes incurred		<u>3,340,941</u>
Net income		<u>\$ 374,521</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2006		\$ 65,431,253
Net income	\$ 374,521	
Change in net unrealized foreign exchange capital gain	234	
Change in net deferred income tax	105,802	
Change in nonadmitted assets	(97,497)	
Aggregate write-ins for losses in surplus	<u>(2,049,000)</u>	
Change in surplus as regards policyholders for the year		<u>(1,665,940)</u>
Surplus as regards policyholders, December 31, 2007		<u>\$ 63,765,313</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2003 through December 31, 2007

Surplus as regards policyholders, December 31, 2003 per Examination			\$ 40,909,878
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 23,107,177	\$	
Net unrealized capital gains	120,381		
Change in net foreign exchange capital losses		124	
Change in net deferred income tax		2,802,669	
Change in provision for reinsurance	<u>2,430,670</u>		
Total gains and losses	<u>\$ 25,658,228</u>	<u>\$ 2,802,793</u>	
Net increase in surplus as regards policyholders			<u>22,855,435</u>
Surplus as regards policyholders, December 31, 2007, per Examination			<u>\$ 63,765,313</u>

Reconciliation of Examination Changes
as of December 31, 2007

<u>Liabilities</u>	<u>Per Corporation</u>	<u>Per Examination</u>	<u>Surplus Increase (Decrease)</u>	<u>Notes</u>
Losses and loss adjustment expenses	\$ 58,090,141	\$64,112,000	\$ (6,021,859)	(1)
Aggregate write-ins for liabilities	4,668	2,053,668	<u>(2,049,000)</u>	(2)
Net decrease to surplus			(8,070,859)	
Surplus as regards policyholders, December 31, 2007, per Corporation			<u>71,836,172</u>	
Surplus as regards policyholders, December 31, 2007, per Examination			<u>\$ 63,765,313</u>	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The California Department of Insurance (Department) retained an independent Consulting Actuary to evaluate the loss and loss adjustment expense reserves (loss reserves) as of December 31, 2007. In addition, a Department Senior Casualty Actuary reviewed the work of our Consulting Actuary, and performed additional analysis as deemed appropriate. Based on the analyses performed by the Department's Consulting Actuary and in-house Senior Casualty Actuary, the Department has determined its best estimate of loss reserves to be \$6,411,246,000 for all companies participating in the intercompany reinsurance pooling agreement. The reserve deficiency primarily relates to adverse development on asbestos and environmental reserves (A&E), which triggered amounts due from Allianz SE under a Keep Well Commitment. The Keep Well Commitment is held by the Company's parent, Fireman's Fund Insurance Company. The Corporation's share of this deficiency totals \$6,022,000. Refer to the table below for the carried vs. estimated reserves for each company in the pool.

<u>Company</u>	<u>Pool Percentage</u>	<u>Indicated Per Department (000)</u>	<u>Carried Per Company (000)</u>	<u>Deficiency (000)</u>
Fireman's Fund Insurance Company	75.0%	\$ 4,808,435	\$ 4,356,761	\$ (451,674)
The American Insurance Company	11.5%	737,293	668,037	(69,256)
National Surety Corporation	4.0%	256,450	232,361	(24,089)
Interstate Fire & Casualty Company	3.5%	224,394	203,315	(21,078)
American Automobile Insurance Company	2.5%	160,281	145,225	(15,056)
Chicago Insurance Company	1.5%	96,169	87,135	(9,033)
Associated Indemnity Corporation	1.0%	64,112	58,090	(6,022)
Interstate Indemnity Company	0.8%	51,290	46,472	(4,818)
Fireman's Fund Insurance Company of Ohio	0.2%	12,822	11,618	(1,204)
Total Pooled Companies	100.00%	\$ 6,411,246	\$ 5,809,014	\$ (602,232)
Vintage Insurance Company	N/A	33	33	0
San Francisco Reinsurance Company	N/A	32,810	25,467	(7,343)
Total All Companies	N/A	\$ 6,444,089	\$ 5,834,514	\$ (609,575)

(2) Aggregate Write-ins for Liabilities: Excess of Statutory Reserves over Statement Reserves

The Corporation did not include a minimum reserve requirement for loss and loss adjustment expenses in its aggregate write-ins for liabilities as required by California Insurance Code (CIC) Section 11558. The additional reserve amount was calculated to be \$2,049,000. It is recommended the Corporation calculate the minimum reserve liability in accordance with CIC Section 11558.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records – Information System Controls (Page 9): As the result of the review of the Corporation’s information systems controls, recommendations for improving these controls were presented to the Corporation. The Corporation should evaluate these recommendations and make appropriate changes to strengthen its controls over its information systems.

Accounts and Records – Federal Income Taxes (Page 9): It is recommended that the Corporation identify and measure temporary differences using a balance sheet approach in compliance with Statement of Statutory Accounting Principles No. 10, paragraph 6.a.

Previous Report of Examination

Accounts and Records - Information Systems Controls (Page 10): It was recommended that the Corporation evaluate the recommendations from the Information Systems review and make appropriate changes to strengthen its information system controls. The Corporation has implemented controls to strengthen its information systems.

Accounts and Records – Reconciliation of Key General Ledger Accounts (Page 11): It was recommended that the Corporation implement controls to ensure that general ledger accounts are

reconciled to the system from which the data feeding the general ledger resides. The Corporation has implemented controls to ensure that general ledger accounts are reconciled to system data.

Comments on Financial Statement Items – Bonds (Page 16): It was recommended the Corporation revise its Custodial Agreement with Mellon Trust of California to include provisions recommended by the NAIC Financial Examiners Handbook. It was also recommended the Corporation submit the revised Agreement to the California Department of Insurance (CDI) for approval. The Corporation amended its custodial agreement to comply with NAIC recommendations. The revised agreement was approved by the CDI on January 25, 2006.

Comments on Financial Statement Items – Common Stocks and Other Invested Assets (Page 17): It was recommended that the Corporation classify Allianz Cash Pool, LLC as Other Invested Assets and report it in Schedule BA. The Corporation has complied with the recommendation.

Comments on Financial Statement Items – Deferred Premiums, Agents' Balances, and Installments Booked but Deferred and Not Yet Due (Page 17): It was recommended the Corporation implement controls to ensure that all accounts subject to pooling are properly pooled and allocated to each member. The Corporation has complied with the recommendation.

Comments on Financial Statement Items – Dividends declared and unpaid – Policyholders (Page 18): It was recommended that the Corporation record policyholder dividends payable in the period in which they are declared. The Corporation has complied with this recommendation.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Corporation's officers and employees during the course of this examination.

Respectfully submitted,

_____/s/_____
Gordon M. Curtis, CFE, CISA
Examiner-In-Charge
Department of Insurance
State of California